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No. 322

In the Supreme Court of the United States

OCTOBER TERM, 1932

THE MASSACHUSETTS MUTUAL LIFE INSURANCE COMPANY, PETITIONER

v.

THE UNITED STATES

ON WRIT OF CERTIORARI TO THE COURT OF CLAIMS

BRIEF FOR THE UNITED STATES

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OPINION BELOW

The opinion of the Court of Claims (R. 16) is reported in 59 F. (2d) 116.

JURISDICTION

The judgment of the court below was entered May 31, 1932. (R. 19.) Petition for a writ of certiorari was filed August 26, 1932, and granted November 7, 1932. (R. 21.) The jurisdiction of this Court rests upon Section 3 (b) of the Act of February 13, 1925.

QUESTION PRESENTED

Whether the petitioner, a life insurance company making its return upon the basis of actual receipts and disbursements, is entitled to deduct from its gross income for 1926, as interest paid, the amount of interest credited by it to its policyholders during 1926 but not withdrawn by them.

STATUTES AND REGULATIONS INVOLVED

Section 245 of the Revenue Act of 1926, c. 27, 44 Stat. 9, 47 (U. S. C. App., Title 26, Sec. 1004), provides in part:

> SEC. 245 (a) In the case of a life insurance company the term "net income" means the gross income less—
>
> * * * * *
>
> (8) All interest paid or accrued within the taxable year on its indebtedness * * *

Article 685 of Treasury Regulations 69, promulgated under the Revenue Act of 1926, provides in part:

> (3) The deduction allowed by section 245 (a) (8) for interest on indebtedness is the same as that allowed other corporations by section 234 (a) (2) (see articles 561 and 121), but this deduction includes item 18 of the disbursement page of the annual statement of life companies to the extent that interest on dividends held on deposit and surrendered during the taxable year is included therein. Dividends left with the company to accumulate at interest are a debt and not a reserve liability.

STATEMENT

The findings of fact made by the Court of Claims (R. 11–15) may be summarized as follows:

Petitioner, a Massachusetts corporation, is a life insurance company selling insurance on the mutual level premium plan. (R. 11.) Its plan of operation contemplates the return to its policyholders, in the form of "dividends," of a portion of its receipts. Its policies provide that the dividends, when declared, may be withdrawn in cash, applied in various ways as premium payments, or allowed to remain on deposit with petitioner. (R. 15.) If the policyholder adopts the last course, the dividends accumulate at interest, which is added at the end of each policy year. The dividends and accrued interest may be withdrawn by the policyholder on demand. (R. 11, 15.) During 1926, the taxable year now in question, for which petitioner filed its income tax on the basis of actual receipts and disbursements, $544,964.40 became due the policyholders as interest on their dividends left with petitioner. (R. 11, 13.) This amount was credited to the individual accounts of the policyholders during 1926 and was subject to withdrawal on demand. The amount of interest actually withdrawn during 1926, however, was only $248,405.97, the major portion of which did not accrue in 1926. (R. 13.) In its income tax return for 1926 petitioner sought to deduct as interest paid during that year the total amount, $544,964.40, credited to the policyholders' accounts, although less than half that

sum, namely, $248,405.97, had been actually paid out. (R. 11.) The Commissioner disallowed the deduction claimed by petitioner, and instead allowed a deduction only of the interest withdrawn by the policyholders. (R. 13.) Petitioner paid the additional tax resulting from the Commissioner's determination of its net income, duly filed its claim for refund (R. 13), and brought this suit to recover the additional tax. The Court of Claims dismissed its petition. (R. 19.)

SUMMARY OF ARGUMENT

Petitioner, like all other life insurance companies, makes its returns on the cash receipts and disbursements basis. The mere accrual of liability to policyholders for interest on dividends not withdrawn in no way affected the cash position of the petitioner. Taxpayers who make their returns on the cash receipts and disbursements basis are not entitled to deduct accrued liabilities, but only actual disbursements. The scheme of income taxation requires consistency in the basis of return, and the Revenue Acts do not contemplate the return of income by any taxpayer, partly on a cash receipts and disbursements basis and partly on an accrual basis.

No departure from the general scheme of taxation was intended by the provisions of Section 245(a)(8) of the Revenue Act of 1926, upon which the petitioner relies. The statute has been consistently construed by the administrative officers as

permitting the deduction only of interest paid. The administrative construction accords with the practice uniformly followed by all life insurance companies in making their returns and in their annual statements. It is reasonable, consistent with the general scheme of taxation, and should therefore be accepted.

There is nothing in the legislative history of Section 245 (a) (8) to indicate that Congress intended the construction for which petitioner contends. Acceptance of that construction is quite inconsistent with the whole scheme of the Revenue Act, and with the practice of petitioner and all other life insurance companies. The words "paid or accrued" have a settled usage in the Revenue Act and are disjunctive in their application. A taxpayer making his return upon the cash basis may deduct interest "paid." A taxpayer making his return on the accrual basis may deduct interest "accrued." As the petitioner kept its books and made its return on a cash receipts and disbursements basis, it is not entitled to deduct interest accrued.

The doctrine of constructive receipt of income applicable to recipients under regulations and decisions has no application here. There is no similar doctrine of constructive payment.

ARGUMENT

Petitioner, like all other life insurance companies, makes its income tax returns on the cash

receipts and disbursements basis.[1] Petitioner claimed the right to deduct upon its 1926 return $544,964.40 credited to its policyholders as interest on dividends left on deposit with petitioner, subject to their withdrawal on demand, but not actually withdrawn. In that year it had paid out in cash to its policyholders, as interest on dividends, a total of $248,405.97. This sum was allowed by the Commissioner as a deduction from gross income for 1926 and the interest accrued was disallowed. Petitioner now treats the allowance by the Commissioner as a partial allowance of the deduction claimed. When petitioner credited $544,964.40 to policyholders in 1926, it merely became indebted to them to that extent without in any way affecting its previous control of its funds. Petitioner's cash position was unaltered. Petitioner, however, contends that it is entitled to deduct from its gross income for 1926 the amount so credited to its policyholders, although, concededly, the interest was not paid in 1926.

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[1] *Bulletin H, Income Tax Rulings Peculiar to Life Insurance Companies*, published April 9, 1921:

"1. *Basis of Returns.*—Returns of life insurance companies shall be made on a receipts and disbursements basis, as distinguished from an accrual basis, as being in accordance with the method of accounting regularly employed by such companies * * *."

I

WHERE TAXPAYERS KEEP THEIR BOOKS ON THE CASH BASIS, NO DEDUCTION MAY BE ALLOWED ON ACCOUNT OF OBLIGATIONS WHICH HAVE ACCRUED BUT HAVE NOT BEEN PAID DURING THE TAXABLE YEAR

Income-tax returns of taxpayers generally must be made on the basis which most truly reflects their net income. See *American National Co.* v. *United States,* 274 U. S. 99, 105; *United States* v. *Anderson,* 269 U. S. 422. Where the returns are made on the cash basis, as here, deductions from gross income may be taken only where actual disbursements have been made.

In *Hart* v. *Commissioner,* 54 F. (2d) 848 (C. C. A. 1st), the taxpayer kept his books on the cash basis. During the taxable year in question, being indebted to a bank in a large amount, he "paid" the interest on his loan by giving his personal note for the sum due. The Commissioner refused to allow a deduction of the amount so "paid." The court, upholding the Commissioner, said (p. 852):

> If the note is never paid, the taxpayer has parted with nothing more than his promise to pay. A promise to pay is not cash, and a deduction from interest [income?] is permissible only in the taxable year in which the taxpayer pays cash. * * *

Here, as in that case, the taxpayer has done no more than promise to pay in the future; in the

meantime it still has full control of its funds, which it can invest and on which it can continue to receive a return. See also *Eckert* v. *Burnet*, 283 U. S. 140, 141–142.

In *United States* v. *Mitchell*, 271 U. S. 9, which held that a taxpayer on a cash basis could not deduct from his gross income Federal estate taxes which accrued but were not paid during the taxable year, this Court said (p. 12):

> It was not the purpose of the Act to permit gross income actually received to be diminished by taxes *or other deductible items* disbursed in a later year, even if accrued in the taxable year. It is a reasonable construction of the law that the same method be applied to both sides of the account. (Italics ours.)

See also *Appeal of Reubel*, 1 B. T. A. 676.

The Board of Tax Appeals has consistently held that taxpayers making their returns on a cash receipts basis may not deduct interest which became due but was not actually paid within the taxable year. See *Appeal of Seaboard Oil Co.*, 1 B. T. A. 1259; *Appeal of Utah Orpheum Co.*, 3 B. T. A. 1041; *Appeal of Georgia State Savings Association*, 4 B. T. A. 748; *The Barto Co.* v. *Commissioner*, 21 B. T. A. 1197. See also *de Paoli* v. *Commissioner*, 8 B. T. A. 294; *Warrick* v. *Commissioner*, 20 B. T. A. 220; *Colvert* v. *Commissioner*, 6 B. T. A. 623; *Mann* v. *Commissioner*, 59 App. D. C. 103.

II

LIFE INSURANCE COMPANIES ARE NOT AUTHORIZED TO DEDUCT INTEREST DUE TO THEIR POLICYHOLDERS, UNLESS ACTUALLY PAID

The principles applicable to other taxpayers keeping their books and making their returns on the cash receipts and disbursements basis, adverted to above, apply equally to life insurance companies. Other taxpayers are not permitted to combine the cash and accrual bases in their returns, and in the absence of a clear declaration of legislative purpose it is not to be supposed that Congress intended life insurance companies to depart from settled principles necessarily applicable to the computation of all income taxes. Apparently conceding that all other taxpayers are required to maintain consistency in their returns, petitioner seeks the right to make a novel hybrid return because of the provision in Section 245 (a)(8) of the Revenue Act of 1926, *supra,* that a life insurance company may deduct from its gross income "all interest paid *or accrued* within the taxable year on its indebtedness." (Italics ours.)

The provision of the 1926 Act now involved first appeared as Section 245(a)(8) of the Act of 1921, c. 136, 42 Stat. 227, 261. This section was reenacted as Section 245(a)(8) of the Act of 1924, c. 234, 43 Stat. 253, 289 (U. S. C., Title 26, Sec. 1004). No change was made in the section when it was reenacted as Section 245(a)(8) of the 1926 Act, *supra.*

It has been reenacted in the same form as Section 203(a)(8) in the Revenue Act of 1928, c. 852, 45 Stat. 791, 842, (U. S. C. Sup. V, Title 26, Sec. 2203), and Section 203(a)(8) of the Revenue Act of 1932, c. 209, 47 Stat. 169, 224.

Treasury Regulations 62, Art. 685(3), applicable to Section 245 (a) (8) of the 1921 Act, provided in effect that the interest payable by insurance companies on dividends which may be deducted is the amount paid out during the taxable year. The regulations state that the deduction for interest on indebtedness "includes item 18 of the disbursement page of the annual statement of life companies * * *."[2] Item 18 is "Dividends and interest thereon surrendered during the year."[3] In the instant case the Commissioner allowed as a deduction the amount shown on item 18 of petitioner's annual statement. The only interest included in this item was "surren-

[2] The annual statement of life insurance companies is a standard form used by all life insurance companies in the United States and prescribed by the National Convention of Insurance Commissioners. (See Section 246 (b) (1), Revenue Act of 1926.) The annual statement is so drawn that the report of a particular company will necessarily be strictly on the cash receipts and disbursements basis.

[3] While the standard form of annual statement is revised from time to time by the commissioners, we are informed that item 18 remained unchanged from the time of promulgation of Regulations 62 through the taxable period involved herein.

dered," that is, paid during the taxable year. (R. 13.)[4]

This regulation was carried forward to the regulations applicable to the 1924 Act, Regulations 65, Art. 685(3), and to Regulations 69, Art. 685(3), applicable to the 1926 Act. Throughout this period the statute remained unchanged.

The administrative construction thus adopted consistently construed the statutory provision in a manner which harmonized with the method of making returns and annual statements followed by all life insurance companies.[5] Such consistent administrative construction was therefore obviously reasonable and is entitled to great weight. See *Murphy Oil Co.* v. *Burnet*, decided December

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[4] Item 18 in the disbursement page of the annual statement of the petitioner for the year 1926 reads as follows:

"18. Dividends $1,767,501.89 and interest $248,405.97 thereon held on deposit surrendered during the year—$2,015,907.86."

The sum which the petitioner desires to deduct appears in its annual statement for 1926 on p. 5, under the heading "Liabilities, Surplus, and Other Funds," as follows:

"22. Dividends left with the company to accumulate at interest, and accrued interest thereon, *including $544,967.40, interest credited during the year and payable on demand* $14,000,669.68." (R. 13.)

[5] We are informed that life insurance companies have without exception made their tax returns on the cash basis since the corporation excise tax provisions of the Tariff Act of 1909, c. 6, 36 Stat. 11, 112, Sec. 38.

5, 1932 (No. 80, October Term, 1932); *Interstate Commerce Commission* v. *New York, New Haven & Hartford Railroad Company,* decided November 21, 1932 (No. 15, October Term, 1932); *McCaughn* v. *Hershey Chocolate Company,* 283 U. S. 488, 492; *Fawcus Machine Co.* v. *United States,* 282 U. S. 375, 378; *Brewster* v. *Gage,* 280 U. S. 327, 336.

Petitioner contends that the administrative construction must be disregarded because it virtually eliminates the words "or accrued" from the provisions of Section 245 (a) (8) and thus is an attempt to abridge statutory provisions which petitioner asserts are plain and unambiguous and require no construction.

It is true that the words "or accrued" can have no application to companies which keep their books upon a cash basis, and it is also true that all life insurance companies do keep their books on this basis. These companies are not, however, required to do so by the statute, and their practice, even when sanctioned by regulation and made the basis of their tax returns, can not change the meaning of the words "paid or accrued," which in their application to taxpayers generally are understood to mean that interest "paid," by taxpayers whose income is returned on a cash basis, "or accrued" on the books of taxpayers whose income is returned on an accrual basis, shall be deducted from gross income. This interpretation is in harmony with the scheme and purpose of the law, the practice of taxpayers

and the administrative rulings which have received legislative approval.[6]

The genesis of Section 245 (a) (8) indicates that the words "or accrued" were incorporated without reference to the practice of life insurance companies in making their returns on the cash basis. Before the Act of 1921 there were no separate provisions applicable to life insurance companies covering the deductions involved in this case. The general provision which applied to all corporations, including life insurance companies, contained only the word "paid," until the Act of 1918, in which the words "or accrued" were added. The Tariff Act of 1913, Sec. II–G (b), c. 16, 38 Stat. 114, 172; Revenue Act of 1916, Section 12 (a) (3), c. 463, 39 Stat. 756, 768; Revenue Act of 1917, Section 1207 (1), c. 63, 40 Stat. 300, 334; Revenue Act of 1918, Section 234 (a) (2), c. 18, 40 Stat. 1057, 1077.

Treasury Regulations applicable to the Act of 1916 provided that the word "paid" was to be construed in accordance with the method of accounting adopted by the taxpayer. See Regulations 33 (1918 ed.), Arts. 126, 180. Thus, under

[6] It is to be noted that, considering the tax liability over a period of future years, it makes no practical difference in tax whether interest paid or accrued is allowed as a deduction, for all interest accrued will eventually be deductible as interest paid. But it is probable that the allowance of interest accrued in a particular year would require readjustment of tax liability for earlier years, and if a larger tax liability for earlier years was disclosed, the statute of limitations might bar collection.

that Act a corporation making return on a cash basis could not deduct interest on indebtedness which accrued but was not paid during the taxable year, while a taxpayer allowed by the Commissioner to make return on an accrual basis (after the Revenue Act of 1916) could deduct interest accrued. The addition of the words "or accrued" in the Act of 1918 did not change the meaning of the section. The word "paid" retained its previous construction (Regulations 45, Arts. 23, 1533), and a corporation's privilege to deduct interest on its indebtedness depending upon its method of accounting remained precisely the same as under the earlier Acts. *Appeal of Seaboard Oil Co.*, 1 B. T. A. 1259. When in 1921 insurance companies were for the first time treated separately, the section permitting deduction of interest was simply copied directly from the similar section applicable generally to corporations. See Revenue Act of 1921, Sec. 234 (a) (2), c. 136, 42 Stat. 227, 254; Revenue Act of 1924, Sec. 234 (a) (2), c. 234, 43 Stat. 253, 283; Revenue Act of 1926, Sec. 234 (a) (2), c. 27, 44 Stat 9. 41. The presumption is that the words had precisely the same meaning in their new setting as they had in their old even though because of accounting practices then in vogue there were no life insurance companies on the accrual basis. If it was the purpose of Congress to engraft on a familiar method of making returns long followed by all life insurance companies, a novel and exotic provision having no relation to the method of re-

turn or of rendering their annual statements, it would be natural to find some consideration of the subject in the Committee Reports, but there is none.

The words "paid or accrued" are disjunctive in their application to two kinds of tax returns—those made upon the cash basis, and those made upon the accrual basis. If return is made upon the cash basis, interest "paid" may be deducted; if upon the accrual basis, interest "accrued" may be deducted. See *United States* v. *Anderson,* 269 U. S. 422, 438–440; *Appeal of Reubel,* 1 B. T. A. 676, 678. The words "or accrued" are not applicable to the petitioner because under the rulings of the Treasury Department and the consistent practice of all life insurance companies which they approve, the cash receipts and disbursement method of accounting is followed by it. In the case of ordinary corporations under Section 234 (a) (2) of the 1926 Act, *supra,* the word "paid" has no application when a corporation makes return on the accrual basis. See *Miller & Vidor Lumber Co.* v. *Commissioner,* 39 F. (2d) 890 (C. C. A. 5th); *United States* v. *Anderson, supra; Appeal of Atlantic Coast Line R. R. Co.,* 2 B. T. A. 892. And the words "or accrued" are likewise inapplicable if the taxpayer makes return on the cash basis. See *United States* v. *Mitchell, supra; Hart* v. *Commissioner, supra.* Similarly, the petitioner, not being on the accrual basis, may deduct interest paid and may not deduct interest accrued.

The result for which petitioner contends requires distortion of the scheme of income taxation applied to all taxpayers. Unless no other result can properly be reached, the statute should not be construed to permit one class of taxpayers, in this respect no different from any other, to return only the gross income actually received during the taxable year and to deduct from that sum not only current expenditures but also payments that are merely anticipated. As the court below observed (R. 18):

> To hold that an amount credited by a taxpayer employing a cash receipts and disbursements method of accounting constitutes a payment, and is, therefore, deductible from gross income in the year in which credited, would destroy the distinction between the accrual and the receipts and disbursements methods of accounting which is recognized and made controlling by the revenue statutes.

III

THE DOCTRINE OF "CONSTRUCTIVE RECEIPT" OF INCOME IS INAPPLICABLE

Petitioner contends that in any event the interest was "constructively paid" during 1926, since, by Regulations 69, Article 51—

> Income which is credited to the account of or set apart for a taxpayer and which may be drawn upon by him at any time is subject to tax for the year during which so credited or set apart, although not then actually reduced to possession. * * *

A number of cases support the regulations and show that taxpayers, even though they keep their books on the cash receipts basis, may "constructively receive" income which has been credited or set apart for them, although not actually taken in cash at the time. See *Hadley* v. *Commissioner*, 36 F. (2d) 543 (App. D C.); *Chipley* v. *Commissioner*, 25 B. T. A. 1103; *Appeal of Brander*, 3 B. T. A. 231; cf. *Commissioner* v. *Bingham*, 35 F. (2d) 503 (C. C. A. 6th), certiorari denied, 281 U. S. 729. But these cases, like the regulations to which they give effect, relate to the taxability of the potential recipient and depend upon the circumstance that funds are subject to the demand of the taxpayer and consequently may be brought under his possession and control at his will. The purpose of the regulations was clearly to prevent evasion or postponement of taxes by one who was entitled to exercise dominion over a fund. But no such purpose could be served by a doctrine of "constructive payment" by a taxpayer. It is for this that petitioner apparently contends. There are no regulations or decisions of which we are aware which establish a rule of constructive payment.

Article 685 (3) of Regulations 69, specifically covers the deductions allowed by Section 245 (a) (8). The statute and the regulations are clear and unmodified by any rule of constructive payment. Such a rule would seem to require a departure from petitioner's method of return. The National Convention of Insurance Commissioners appar-

ently has never recognized it in prescribing the form of annual statement and apparently it has never been applied to the returns of life insurance companies either by taxpayers or the Commissioner.

CONCLUSION

The judgment of the Court of Claims is correct and should be affirmed.

Respectfully submitted.

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